No. 22,580

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

PACIFIC MUTUAL LIFE INSURANCE COMPANY,

Respondent.

On Petition for Review of the Decision of the Tax Court of the United States.

BRIEF FOR THE RESPONDENT.

FILED

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On Petition for Review of the Decision of the Tax Court of the United States.

BRIEF FOR THE RESPONDENT.

Opinion Below.

The opinion of the Tax Court [I-R 127-179] is reported at 48 T.C. 118.

Jurisdiction.

This petition for review [I-R 183-185] involves federal income taxes for the years 1958 through 1961. On December 24, 1964, the Commissioner of Internal Revenue mailed to the respondent a notice of deficiency, asserting deficiencies in income taxes in the aggregate amount of $318,659.72 for the calendar years 1958 through 1961. [I-R 9-36.] Within ninety days thereafter, on March 2, 1965, the respondent filed a

petition with the Tax Court for a redetermination of those deficiencies under the provisions of Section 6213 of the Internal Revenue Code of 1954. [I-R 1-36.] The decision of the Tax Court was entered on August 28, 1967. [I-R 182.] The case is brought to this Court by a petition for review filed on November 17, 1967 [I-R 183-185], within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

Question Presented.

Whether the Tax Court was correct in its determination that the guaranteed renewable accident and health insurance contracts issued by respondent were "issued or renewed for periods of 5 years or more" within the purview of Section 809(d)(5) of the Internal Revenue Code of 1954.

Statute and Regulations Involved.

Internal Revenue Code of 1954:

Subchapter L—Insurance Companies

Part I. Life insurance companies.

* * *

PART I—LIFE INSURANCE COMPANIES

Subpart A. Definition; tax imposed.

* * *

Subpart C. Gain and loss from operations.

* * *

Subpart A—Definition; Tax Imposed

SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY.

* * *

(e) Guaranteed Renewable Contracts.—For purposes of this part, guaranteed renewable life, health, and accident insurance shall be treated in the same manner as noncancellable life, health, and accident insurance.

* * *

(26 U.S.C. 1964 ed., Sec. 801(e))

Subpart C—Gain and Loss from Operations

SEC. 809. IN GENERAL.

* * *

(d) Deductions.—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

* * *

(5) Certain Nonparticipating Contracts.—An amount equal to 10 percent of the increase for the taxable year in the reserves for nonparticipating contracts or (if greater) an amount equal to 3 percent of the premiums for the taxable year (excluding that portion of the premiums which is allocable to annuity features) attributable to nonparticipating contracts (other than group contracts) which are issued or renewed for periods of 5 years or more. For purposes of this paragraph, the term "reserves for nonparticipating contracts" means such part of the life insurance reserves (excluding that portion of the reserves which is allocable to an-

nuity features) as relates to nonparticipating contracts (other than group contracts). For purposes of this paragraph and paragraph (6), the term "premiums" means the net amount of the premiums and other consideration taken into account under subsection (c)(1).

* * *

(26 U.S.C. 1964 ed., Sec. 809)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.801-3. Definitions.

* * *

(d) *Guaranteed renewable life, health, and accident insurance policy.* The term "guaranteed renewable life, health, and accident insurance policy" means a health and accident contract, or a health and accident contract combined with a life insurance or annuity contract, which is not cancellable by the company but under which the company reserves the right to adjust premium rates by classes in accordance with its experience under the type of policy involved, and with respect to which a reserve in addition to the unearned premiums (as defined in paragraph (e) of this section) must be carried to cover that obligation. Section 801(e) provides that such policies shall be treated in the same manner as noncancellable life, health, and accident insurance policies. * * *

* * *

(26 C.F.R., Sec. 1.801-3(d))

Sec. 1.809-5. Deductions.

(a) *Deductions allowed.* Section 809(d) provides the following deductions for purposes of determining gain or loss from operations under section 809(b)(1) and (2), respectively:

* * *

(5) *Certain nonparticipating contracts.*

* * *

(iv) * * * The determination of whether a contract meets the 5-year requirement shall be made as of the date the contract is issued, or as of the date it is renewed, whichever is applicable. Thus, a 20-year nonparticipating endowment policy shall qualify for the deduction under section 809(d)(5), even though the insured subsequently dies at the end of the second year, since the policy is issued for a period of 5 years or more. However, a 1-year renewable term contract shall not qualify, since as of the date it is issued (or of any renewal date) it is not issued (or renewed) for a period of 5 years or more. In like manner, a policy originally issued for a 3-year period and subsequently renewed for an additional 3-year period shall not qualify. However, if this policy is renewed for a period of 5 years or more, the policy shall qualify for the deduction under section 809(d)(5) from the date it is renewed.

* * *

(26 C.F.R., Sec. 1.809-5).

Statement.

The petitioner's statement of the case is largely a repetition of the facts as found by the Tax Court. Inasmuch as the respondent does not controvert any of those facts, it shall not repeat them here.

Summary of Argument.

Respondent, a life insurance company, sold a guaranteed renewable accident and health contract providing disability income benefits which was available only to insureds whose age did not exceed 59 years at date of issue. Under the terms of the contract, the insured was guaranteed the right to renew the contract for consecutive periods of one year each to age 65 by payment of the renewal premium for each such term.

It is thus apparent that respondent, under the terms of its contract, as opposed to a "1-year renewable term contract" which is *not guaranteed* renewable, could not refuse annual renewal. In substance then the contract under consideration guaranteed the insured's renewal right, not for successive one year periods, but for a period from date of issue to age 65, or for a period of five years or more.

Although respondent reserved the right to change the annual premium, its right to do so was subject to substantial limitations. Under the terms of the contract, any such change had to be made as to all insureds in the same rate class, irrespective of changes in the insured's physical condition or occupation. Re-

spondent's right to change the annual premium was further limited by circumstances beyond the control of respondent. In the first place respondent reserved the right to change the premium only if, as and when the experience for the class failed to continue as it had in the past. Thus, respondent's right to change the premium was subject to an ascertainable standard based upon its past experience. Moreover, any change in the premium was dependent upon the experience of the class under the policies issued, all of which involves external matters over which respondent has little, if any, control. In the second place, competitive forces within the insurance industry precludes any increase in the premium to any unreasonable limit.

Respondent computed the premium rates on the basis that the premium would remain level to age 65, the same as it does for a life insurance policy with a term to age 65. Respondent issued the policies on the basis that they were guaranteed renewable to age 65 and that the premium rate would remain level from date of issue to age 65 if the experience for the class continued substantially as it had in the past. In recognition of respondent's assumption of long-term risks under the contract, respondent was required by state insurance regulatory authorities to establish and maintain reserves with respect to the contracts under consideration in the same manner as was required with respect to noncancellable policies.

In addition and of greater significance Congress, by statutory definition contained in Section 801(e) of the

Internal Revenue Code of 1954, has clearly stated that guaranteed renewable life, health and accident insurance shall be treated in the *same manner* as noncancellable life, health and accident insurance. Thus, Section 801(e) requires that respondent's contracts be treated, for purposes of Section 809(d)(5), as if they were noncancellable, i.e., as if respondent was not entitled to change the premium charged for any annual renewal.

The language of Section 809(d)(5) is plain and unambiguous. It provides an alternative deduction in an amount equal to "3 percent of the premiums * * * attributable to nonparticipating contracts * * * which are issued or renewed for periods of 5 years or more". The only requirement contained therein relates to the length of time for which a nonparticipating contract must be issued, namely, five years or more. The Tax Court correctly held that the contracts under consideration are nonparticipating contracts which were issued for a period of five years or more within the meaning of Section 809(d)(5).

ARGUMENT.

The Tax Court Correctly Held That Respondent's Guaranteed Renewable Accident and Health Policies Do Qualify as "Nonparticipating Contracts * * * Which Are Issued or Renewed for Periods of 5 Years or More" and, Therefore, Premiums Attributable to Them Are Includible in Computing the Alternative Deduction Provided by Section 809(d)(5) of the 1954 Code.

A. The Nature and Provisions of the Insurance Contracts Involved.

There is no dispute as to the provisions of the insurance contracts involved on this review. All of the provisions of a typical contract are contained in Exhibit 29-AC which is characterized as a "Guaranteed Renewable Income Protection Policy". The contracts provided disability income benefits and were issued only to those persons who were 59 years of age or less at the date of issue. [I-R 173; II-R 93.] Under the terms of such policy, the insured was given the right to renew the policy for consecutive periods of 1 year each to age 65 by payment of the renewal premium for each such term. [I-R 173; Ex. 29-AC.] Respondent, as the insurer, reserved the right to change the renewal premium on the basis of its applicable rate tables in effect on the due date provided that (1) no change was made in the rate tables applicable to the insured's policy unless such change was also made applicable to all policies providing like benefits and renewal rights and in the same rating class; (2) the rating class of the insured's policy was not changed because of any change in the insured's status, such as change of physical conditions or occupation; and (3) each renewal

premium was to be determined in accordance with the rating class and age of the insured at the date of issue. [I-R 173; Ex. 29-AC.]

It is apparent under the terms of such policy that the insured, at date of issue, was guaranteed the right to continue his policy in force for a period of five years or more because his age could not exceed 59 years at date of issue and he was given the right to renew the policy until age 65. It is also apparent that, during this same period of time, the respondent, as the insurer, had no right to alter or amend the provisions of the policy in any respect whatsoever or to cancel the policy except for nonpayment of the renewal premium, a right which is reserved by all insurers in all instances.

Although respondent, as the insurer, did reserve the right to change the amount of the renewal premium, any such change had to be made as to all insureds in the same rate class. In addition and of greater significance to the insured the contract provided that the rating class of his policy could not be changed because of any change in his physical condition or occupation and each renewal premium was to be determined in accordance wth the rating class and age of the insured at the date of issue.

Respondent, as the insurer, computed the premium rates on the policies on the basis that the premium would remain level to age 65, the same as it does for a life insurance policy with a term to age 65. [I-R 173; II-R 93-94.] In order to provide a premium which would remain level from date of issue to age 65, respondent, as the insurer, computed its premium rates for the policies here material on the basis of past ex-

perience and calculations, taking into consideration the fact that it would be necessary to set aside a portion of the premium received during the early policy years to offset the higher costs of insurance in later years as the insured approached age 65. [II-R 94.]

The policies here material were issued for a guaranteed period of not less than five years and for guaranteed periods substantially in excess of five years depending upon the age of the insured at date of issue which could not exceed 59 years. [II-R 93-94.] It is thus apparent that respondent, as the insurer, computed its premium rates based on past experience and the assumption of long-term risks for periods substantially in excess of five years. [II-R 93-94.]

Respondent sold the policies here material to insureds on the basis that they were guaranteed renewable to age 65 and that the premium rate would remain level from age at date of issue to age 65 if the experience continued substantially as it had in the past. [II-R 94.]

Section 997(b) of the Insurance Code of the State of California, provides in part as follows:

> "(b) Every admitted insurer which issues one or more of the following three types of individual disability policies shall maintain a reserve not less than the minimum reserve required under the provisions of this subsection (b):
>
> (1) Policies which are guaranteed renewable for life or to a specified age at guaranteed premium rates.
>
> (2) Policies which are guaranteed renewable for life or to a specified age but under which the insurer has reserved the right to change the scale of premiums."

Thus, it was necessary for respondent, as the insurer, to establish and maintain reserves with respect to the guaranteed renewable accident and health policies here material on the same basis as was required with respect to noncancellable policies providing guaranteed premium rates. [I-R 95.]

B. The Special Deduction Provided by Section 809(d)(5) and the Requirement That Premiums Included Be Attributable to Contracts "Issued or Renewed for Periods of 5 Years or More".

The language of Section 809(d)(5) is plain enough. It allows a life insurance company an alternative deduction in computing its gain or loss from operations equal to "3 percent of the premiums * * * attributable to nonparticipating contracts * * * which are issued or renewed for periods of 5 years or more". Section 809-(d)(5) of the Internal Revenue Code of 1954, *supra.*

A nonparticipating insurance contract is one wherein the policyholder has no right to participate in the divisible surplus of the company. Section 1.809-5(a)-(5)(ii), Treasury Regulations on Income Tax (1954). The contracts under consideration are nonparticipating insurance contracts. [Ex. 29-AC.] The sole question presented, therefore, is whether the contracts under consideration were "issued or renewed for periods of 5 years or more" within the purview of Section 809(d)(5) of the Internal Revenue Code of 1954.

The Senate, in discussing the minimum five-year requirement, stated (S. Rep. No. 291, 86th Cong., 1st Sess., p. 55 (1959-2 Cum. Bul. 770, 810)):

> "* * * The determination of whether a contract meets the 5-year requirement will be made as of

the date it was issued, or as of the date it was renewed, whichever is applicable. Thus, a 20-year nonparticipating endowment policy will qualify under section 809(d)(5), even though the individual insured subsequently dies at the end of the second year, since the policy was issued for a period of 5 years or more. *However, a 1-year renewable term contract will not qualify, in that, as of the date it was issued (or of any renewal date) it was not issued (or renewed) for a period of 5 years or more.* In like manner, a policy originally issued for a 3-year period and subsequently renewed for an additional 3-year period will not qualify. However, if this policy were renewed for a period of 5 years or more, the policy would qualify under section 809(d)(5) from the date it was renewed. * * *" (Emphasis added.)

It is apparent from the language contained in Section 809(d)(5) and the Senate Report that any nonparticipating contract (other than a group contract) which meets the five-year requirement as of the date of issue, or renewal, whichever is applicable, will qualify for the benefits of that section. The only limitation contained therein relates to the length of time for which the policy is issued or renewed. There is no express or implied requirement contained therein that the premium attributable to such contracts remain fixed.

Although a "1-year renewable term contract" does not qualify for the deduction, a contract which guarantees the right of the insured to coverage for a period of five years or more clearly does qualify.

C. The Tax Court Correctly Held That Respondent's Contracts Were Issued for Periods of Five Years or More Within the Purview of Section 809(d)(5).

The contracts under consideration were issued only to those persons who were 59 years of age or less on the date of issue. Although the contracts were issued for an initial term of one year, the insured was guaranteed the right to renew the policy for consecutive terms of one year each to age 65 by the mere payment of the annual renewal premium. Thus, it is apparent under the terms of such policy that the insured, at date of issue, was guaranteed the right to continue his policy in force for a period of five years or more because his age could not exceed 59 years at date of issue and he was given the right to renew the policy until age 65. Correspondingly, during this same period of time, the respondent, as the insurer, had no right to alter or amend the provisions of the policy in any respect whatsoever or to cancel the policy except for nonpayment of the renewal premium, a right which is reserved by all insurers in all instances. Although respondent, as the insurer, reserved the right to change the renewal premium, any such change had to be made as to all insureds in the same rate class, irrespective of any changes in the insured's physical condition or occupation. Thus, at date of issue, an insured could continue his policy in force for a period of "five years or more" by the timely payment of his renewal premium. Hence, the contracts under consideration do meet the five-year test for qualification.

Petitioner contends on pages 17 to 21 of his brief that the contracts under consideration are indistinguishable from a "1-year renewable term contract"

which the Senate Report, *supra,* states specifically will not qualify for the deduction. (P. 55, 1959-2 Cum. Bul., p. 810.) In rejecting this same contention, the Tax Court in the present case was eminently sound when it concluded as follows [I-R 178-179]:

> "While we do not question the fact that petitioner retained the right to alter renewal premiums on the contracts in question, we note, as set forth in our findings, *supra,* that those contracts imposed substantial limitations on such premium changes. In addition and of greater significance in distinguishing petitioner's guaranteed renewable contracts from the 1-year renewable term contracts referred to in the above-quoted Senate committee report, is the fact that, under the former contracts, petitioner guaranteed the renewal of the policies and all their provisions for a period of 5 years or more. Thus, the only way the term of petitioner's guaranteed renewable contracts could have been shortened to less than 5 years was for an insured to either voluntarily cancel his policy or fail to make timely premium payments thereon. Since these possibilities are within the exclusive control of the insured and exist not only with regard to petitioner's guaranteed renewable contracts but with virtually all insurance contracts 'issued or renewed for a period of 5 years or more,' we think the insurance contracts in question satisfy the statutory definition of section 809(d)(5) in that they are, in essence, 'issued * * * for periods of 5 years or more.' The 1-year option guarantee is not a 'renewal' but rather part and parcel of the original insurance contract. The insured's coverage un-

der the contract continues for the full 5-year period subject only to petitioner's right to increase annual premiums within stated limits. In substance, the contract guarantees the insured's 'renewal' right, not for 5 successive yearly periods, but for one 5-year period with the right in petitioner to alter the premium. * * *"

It must be recognized that respondent, in the case of its guaranteed renewable contract, as opposed to a "1-year renewable term contract" which is *not guaranteed* renewable, cannot refuse annual renewal. Thus, in substance, the contract under consideration guarantees the insured's "renewal" right, not for successive one year periods, but for a period (from date of issue to age 65) of five years or more with the right in respondent to change the annual premium.

Although respondent did reserve the right to change the annual premium, any such change had to be made as to all insureds in the same rate class. In addition and of greater significance to the insured the rating class of his policy could not be changed because of any change in his physical condition or occupation and each renewal premium was to be determined in accordance with the rating class and age of the insured at the date of issue. [Ex. 29-AC.] The Tax Court correctly held that these limitations were indeed substantial. [I-R 178.]

Petitioner contends on pages 9 to 10 and 18 to 21 of his brief that the right to change the annual premium is tantamount to the right to force termination of coverage. In doing so petitioner ignores reality and the very nature of the contracts under consideration and the very basis upon which these contracts were sold

to the general public in the ordinary course of respondent's insurance business.

Respondent did not reserve an absolute right to arbitrarily increase the annual premium. A guaranteed renewable accident and health contract is defined in petitioner's Regulations to mean a contract which is *not cancellable* by the company but under which the company reserves the right to adjust premium rates by classes *in accordance with its experience* under the type of the policy involved. Section 1.801-3(d), Treasury Regulations of Income Tax (1954).

Pursuant to the contracts under consideration respondent reserved the right to change the annual premium only, if, as and when the experience for the class failed to continue as it had in the past. [II-R 94.] It is thus apparent that respondent's right to change the premium was subject to an ascertainable standard based upon its past experience. Moreover, any change in the premium contemplated by the respondent and the insureds was dependent upon the experience of the class under the policies issued, all of which involves external matters over which respondent has little, if any, control.

In addition any proposed increase in premium is necessarily limited by competitive forces in the insurance industry. For example, although experience on a given policy may be poor, certain lives will be good risks and other lives poor risks. If the rate is increased to an unreasonable level, a substantial portion of the good risks will obtain insurance coverage elsewhere and leave the insurer with predominantly poor risks. The result will be an even poorer loss ratio than existed before the rate increase.

Moreover, respondent computed the premium rates on the policies on the basis that the premium would remain level to age 65, the same as it does for a life insurance policy with a term to age 65. [I-R 173; II-R 93-94.] In order to provide a premium which would remain level from date of issue to age 65, respondent computed its premium rates on the basis of past experience and calculations, taking into consideration the fact that it would be necessary to set aside a portion of the premium received during the early policy years to offset the higher costs of insurance in later years as the insured approached age 65. [II-R 94.]

The policies here material were issued for guaranteed periods of not less than five years and for periods substantially in excess of five years depending upon the age of the insured at date of issue, which could not exceed 59 years. [II-R 93-94.] It is thus apparent that respondent computed its premium rates based on past experience and the assumption of long-term risks for periods substantially in excess of five years, namely, from date of issue to age 65, the same as it does for a life insurance policy with a term to age 65. [II-R 93-94.]

Likewise, Respondent sold the policies here material to insureds on the basis that they were guaranteed renewable to age 65 and that the premium rate would remain level from date of issue to age 65 if the experience continued substantially as it had in the past. [II-R 94.]

Respondent is engaged in the insurance business, which depends in large part upon the insured's trust and confidence in the integrity and financial responsibility of the insurer. Having issued a policy on the

basis that it was guaranteed renewable to age 65 and that the premium would remain level until age 65 providing the experience for the class continued as it had in the past, it is unreasonable to conclude that respondent's right to change the premium is tantamount to the right to force a termination of coverage. Respondent wishes to continue, not liquidate, its insurance business.

Petitioner contends on pages 7, 9 to 10 and 18 to 21 of his brief that respondent is free, by reason of its right to change the premium, to shift, after one year, any increase in the risk to the insureds as a class and that such a right precludes the contracts from qualification for the deduction.

Respondent respectfully submits that, for the reasons stated above, its right to change the premium is subject to substantial limitations. It must also be recognized that respondent did indeed assume long-term risks which were not cancellable by it and for periods substantially in excess of five years. [I-R 173; II-R 93; Ex. 29-AC.] Thus, the premium rates were calculated, and the contracts were issued, on the basis that the premium would remain level from date of issue to age 65, or for a period substantially in excess of five years, providing the experience thereunder continued as in the past. [I-R 173; II-R 93-94.]

Moreover, respondent sold the policies here material to insureds on the basis that they were guaranteed renewable to age 65 and that the premium rate would remain level from date of issue to age 65 if the experience continued substantially as it had in the past. [II-R 94.] Under the circumstances it is apparent that respondent intended, and did in fact, assume risks for a period of five years or more.

In recognition of respondent's assumption of long-term risks under the contract, respondent is required by state insurance regulatory authorities to establish and maintain its reserves with respect to the contracts under consideration in the same manner as was required with respect to noncancellable policies, providing guaranteed premium rates. [I-R 95; Section 997(b) of the Insurance Code of the State of California.]

Recognizing the industrywide treatment of guaranteed renewable insurance contracts as noncancellable contracts, Congress enacted Section 801(e) which provides that:

> "(e) Guaranteed Renewable Contracts.—For purposes of this part, guaranteed renewable life, health, and accident insurance shall be treated *in the same manner* as noncancellable life, health, and accident insurance." (Emphasis added.)
>
> (26 U.S.C. 1964 ed., Sec. 801(e).)

Petitioner contends on pages 21 to 24 of his brief that this definition has meaning only insofar as it relates to *reserves* and the primary formula under Section 809(d)(5) which is based upon reserves. However, Section 801(e) plainly states that the definition provided shall apply "for purposes of this *part*" (emphasis added) which includes *all* of the sections relating to the taxation of life insurance companies. More specifically Section 801(e) is contained in Part I of Subchapter L and Section 809(d)(5) is similarly contained in Part I of Subchapter L. It is submitted, therefore, that Congress intended respondent's guar-

anteed renewable accident and health contracts should be accorded the same treatment as any noncancellable accident and health contract for purposes of the alternative formula under Section 809(d)(5) based upon "an amount equal to 3 percent of * * * premiums * * *", providing the contracts were issued for five years or more. Any other interpretation ignores the plain meaning of the statute.

In addition and of greater significance is the fact that the language of Section 809(d)(5) is plain and unambiguous. It allows an alternative deduction equal to "3 percent of the premiums * * * attributable to nonparticipating contracts * * * which are issued or renewed for periods of 5 years or more". It is apparent from the language contained in Section 809(d)(5) and the Senate Report, *supra,* that any nonparticipating contract which is issued for five years or more will qualify for the benefits of that section. The only limitation contained therein relates to the length of time for which the policy is issued or renewed. There is no express or implied requirement contained therein that the premium attributable to such contracts remain fixed. Nor indeed does there appear to be any mention in the Senate Hearings or Report that the premium attributable to nonparticipating contracts must be guaranteed. The sole requirement established by Congress under Section 809(d)(5) is that a nonparticipating contract be issued or renewed for a period of five years or more. The Tax Court correctly held that respondent's

contracts were issued for periods of five years or more within the purview of Section 809(d)(5).

Conclusion.

The opinion and decision of the Tax Court were in all respects sound and should be affirmed.

Dated July 3rd, 1968.

Respectfully submitted,

A. Calder Mackay,
Richard N. Mackay,
Counsel for Respondent.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

RICHARD M. MACKAY